



**Consolidated Financial Statements  
As at and for the years ended  
December 31, 2008 and 2007**

**Dated April 1, 2009**

**Epsilon Energy Ltd.  
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## MANAGEMENT'S REPORT

The consolidated financial statements of Epsilon Energy Ltd. were prepared by management within acceptable limits of materiality and are in accordance with Canadian generally accepted accounting principles. Management is responsible for ensuring that the financial and operating information presented in this annual report is consistent with that shown in the consolidated financial statements. Timely release of financial information sometimes necessitates the use of estimates when transactions affecting the current accounting period cannot be finalized until future periods. When necessary, such estimates are based on informed judgments made by management.

Management has designed and maintains an appropriate system of internal controls to provide reasonable assurance that all assets are safeguarded and financial records properly maintained to facilitate the preparation of consolidated financial statements for reporting purposes.

Deloitte & Touche LLP, an independent firm of Chartered Accountants appointed by the shareholders, has conducted an examination of the corporate and accounting records in order to express their opinion on the consolidated financial statements. The Audit Committee, consisting of three independent directors, has met with representatives of Deloitte & Touche LLP and management in order to determine if management has fulfilled its responsibilities in the preparation of the consolidated financial statements. The Board of Directors has approved the consolidated financial statements.

(signed)

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Fred Zaziski  
President and Chief Executive Officer  
April 1, 2009

(signed)

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Dennis Tatum  
Chief Financial Officer



## AUDITORS' REPORT

To the Shareholders of  
Epsilon Energy Ltd.

We have audited the consolidated balance sheets of Epsilon Energy Ltd. as at December 31, 2008 and 2007 and the consolidated statements of operations and deficit, of comprehensive income (loss) and of cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the corporation as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Toronto, Ontario  
April 1, 2009

  
CHARTERED ACCOUNTANTS  
Licensed Public Accountants

**EPSILON ENERGY LTD.**  
**Consolidated Balance Sheets**  
*(All amounts stated in US\$)*

	<b>As at December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents.....	\$ 8,233,442	\$ 47,075,600
Accounts receivable (Note 4).....	7,139,107	574,906
Notes Receivable (Note 5).....	359,401	-
Other current assets.....	262,979	335,428
Total current assets.....	15,994,929	47,985,934
<b>Property and equipment:</b>		
Property and equipment (Note 7 and Note 11).....	84,353,485	67,718,086
<b>Other assets:</b>		
Convertible Debenture (Note 6).....	-	-
Restricted cash (Note 9).....	33,703,308	1,100,000
Other deferred charges and miscellaneous assets.....	17,842	519,112
Total other assets.....	33,721,150	1,619,112
<b>Total assets.....</b>	<b>\$ 134,069,564</b>	<b>\$ 117,323,132</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued liabilities (Note 8).....	\$ 14,636,468	\$ 9,502,157
Line of credit (Note 9).....	19,184,134	-
Current portion of notes payable (Note 10).....	15,574	-
Total current liabilities.....	33,836,176	9,502,157
<b>Long-term liabilities:</b>		
Notes payable (Note 10).....	18,999	-
<b>Other liabilities:</b>		
Asset retirement obligations (Note 11).....	319,763	181,104
Future income tax liabilities (Note 12).....	2,600,000	-
Total other liabilities.....	2,919,763	181,104
<b>Total liabilities.....</b>	36,774,938	9,683,261
<b>Commitments and Contingencies (Note 14).....</b>	-	-
<b>Shareholders' equity:</b>		
	Issued and Outstanding Common Shares	
	As of December 31,	Amount
	2008	50,315,323
	2007	45,698,323
Share capital (Note 13).....	138,259,259	109,725,936
Warrants (Note 13).....	-	11,269
Contributed surplus (Note 13).....	5,401,361	1,512,133
Retained earnings (deficit).....	(36,558,958)	(2,871,042)
Accumulated other comprehensive income (loss)		
(Note 3 and Note 13).....	(9,807,036)	(738,425)
Sub total.....	(46,365,994)	(3,609,467)
Total shareholders' equity.....	97,294,626	107,639,871
<b>Total liabilities and shareholders' equity.....</b>	<b>\$ 134,069,564</b>	<b>\$ 117,323,132</b>

**APPROVED ON BEHALF OF THE BOARD OF DIRECTORS**

(signed) Michael Talmage

(signed) Raymond Savoie

**The accompanying notes are an integral part of these consolidated financial statements**

**EPSILON ENERGY LTD.**  
**Consolidated Statements of Operations and Deficit**  
*(All amounts stated in US\$)*

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Revenues:</b>		
Oil and natural gas revenues .....	\$ 8,012,317	\$ 3,670,159
Other revenues .....	287,232	-
Total revenues.....	8,299,549	3,670,159
<b>Operating costs and expenses:</b>		
Project operating costs .....	1,792,252	538,977
Impairment of unproved properties (Note 7) .....	34,099,133	-
Impairment of investment in convertible debenture (Note 6) ...	-	1,115,419
Amortization, depletion and accretion .....	2,071,421	1,353,712
General and administrative .....	7,518,847	3,736,897
Total operating costs and expenses.....	45,481,653	6,745,005
<b>Operating loss</b> .....	(37,182,104)	(3,074,846)
<b>Other income:</b>		
Gain on sale of assets (Note 7).....	5,013,129	-
Other income.....	1,081,059	851,259
Total other income .....	6,094,188	851,259
<b>Net loss before income taxes</b> .....	(31,087,916)	(2,223,587)
<b>Income taxes:</b>		
Future income tax expense.....	2,600,000	-
<b>Net loss</b> .....	(33,687,916)	(2,223,587)
<b>Deficit, beginning of year</b> .....	(2,871,042)	(647,455)
<b>Deficit, end of year</b> .....	\$ (36,558,958)	\$ (2,871,042)
<b>Basic and diluted loss per share</b> .....	\$ (0.71)	\$ (0.08)
<b>Weighted average number of shares outstanding</b> .....	47,504,436	27,147,760

**The accompanying notes are an integral part of these consolidated financial statements**

**EPSILON ENERGY LTD.**  
**Consolidated Statements of Cash Flows**  
*(All amounts stated in US\$)*

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net loss for the year	\$ (33,687,916)	\$ (2,223,587)
Items not involving cash:		
Amortization, depletion and accretion.....	2,071,421	1,353,712
Impairment of unproved properties .....	34,099,133	-
Stock based compensation.....	1,846,518	1,389,576
Net gain on assets sold (Note 7) .....	(5,013,129)	-
Future income tax expense .....	2,600,000	-
Realized foreign exchange gains and losses.....	-	(161,300)
Impairment of investment in convertible debenture .....	-	1,115,419
Changes in non-cash balances related to operations (Note 18) .....	(8,512,486)	(357,419)
Net cash provided by or (used in) Operating activities.....	(6,596,459)	1,116,401
<b>Cash flows from investing activities:</b>		
Additions to oil and natural gas properties (Note 18).....	(47,265,342)	(42,267,814)
Additions to other property and equipment .....	(345,629)	(110,749)
Proceeds from sale of assets (Note 7).....	6,768,025	-
Changes in restricted cash .....	(32,603,308)	(1,100,000)
Changes in other assets and other liabilities .....	501,270	(538,639)
Net cash used in investing activities .....	(72,944,984)	(44,017,202)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of Common Shares and warrants, net of issuance costs (Note 18) .....	31,256,168	83,407,649
Re-purchase of Common Shares (Note 18) .....	(691,405)	-
Proceeds from line of credit (Note 9) .....	19,184,134	-
Change in long-term debt .....	18,999	-
Net cash provided by financing activities.....	49,767,896	83,407,649
<b>Effect of currency rates on cash and cash equivalents .....</b>	<b>(9,068,611)</b>	<b>(728,278)</b>
(Decrease) or increase in cash .....	(38,842,158)	39,778,570
Cash and cash equivalents at beginning of year .....	47,075,600	7,297,030
<b>Cash and cash equivalents at end of year .....</b>	<b>\$ 8,233,442</b>	<b>\$ 47,075,600</b>
<b>Cash and cash equivalents consist of:</b>		
Cash.....	\$ 5,009,389	\$ 16,493,600
Interest bearing short-term deposits.....	3,224,053	30,582,000
Total cash and cash equivalents.....	\$ 8,233,442	\$ 47,075,600
<b>Supplementary cash flow information:</b>		
Interest received.....	\$ 1,430,515	\$ 386,826
Interest paid .....	\$ 75,058	\$ -
Income taxes paid .....	\$ -	\$ -

**Non cash transactions:**

The Corporation had non-cash transactions during the presented periods. See Note 18 "Changes in Non-Cash Balances Related to Cash Flows".

**The accompanying notes are an integral part of these consolidated financial statements**

**EPSILON ENERGY LTD.**  
**Consolidated Statements of Comprehensive Income (Loss)**  
*(All amounts stated in US\$)*

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Net loss .....	\$ (33,687,916)	\$ (2,223,587)
Other comprehensive loss:		
Unrealized foreign exchange losses (Note 3 and Note 13).....	(9,068,611)	(728,278)
<b>Comprehensive loss (Note 3 and Note 13)</b> .....	<b>\$ (42,756,527)</b>	<b>\$ (2,951,865)</b>

**The accompanying notes are an integral part of these consolidated financial statements**

# **Epsilon Energy Ltd.**

## **Notes to the Consolidated Financial Statements**

### **1. Description of Business and Going Concern**

Epsilon Energy Ltd. (the “Corporation” or “Epsilon”) was incorporated under the laws of the Province of Alberta on March 14, 2005. On October 24, 2007, the Corporation became a publicly traded entity on the Toronto Stock Exchange under the trading symbol “EPS”. The Corporation is engaged in the acquisition, exploration, development and production of oil and natural gas reserves in the United States, Canada, the Republic of Yemen (“Yemen”) and the Federal Democratic Republic of Ethiopia (“Ethiopia”).

The financial statements of the Corporation have been prepared on a going concern basis, which presumes that the Corporation will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The Corporation is relying upon its ability to continue to achieve profitable oil and natural gas production from its projects to continue as a going concern. Given the lead time associated with the many of its exploration and development activities, the Corporation’s ability to continue as a going concern is dependent on many factors. Those factors include the results of future exploration, development and production activities, the timing, scope and pace of such activities, and events outside of the Corporation’s direct control, such as the global credit market crisis and oil and gas commodity price volatility.

The Company has experienced net operating losses every year since its inception in 2005. Factors that will affect the Corporation’s ability to continue as a going concern include:

- Continued commercial production from its existing producing properties;
- Commencement of commercial natural gas production from its Highway 706 project during 2009;
- Managing future international exploratory activities in a cost effective manner;
- Effectively managing the timing, pace, scope and the allocation of funds for capital expenditures within currently available capital resources; and
- Raising additional capital, as warranted, to accelerate or supplement the Corporation’s capital expenditures by bringing in industry partners, additional debt financing, equity financing, sale of a full or partial property interests, or a combination thereof.

The accompanying consolidated financial statements do not include any adjustments that might result if the Company is unable to continue as a going concern.

### **2. Accounting Policies**

#### **(a) Basis of Presentation**

The Corporation’s financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

All currency amounts are in U.S. dollars (US\$), unless stated otherwise.

#### **(b) Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries. All inter-company transactions have been eliminated.

### **(c) Cash and Cash Equivalents**

Cash and cash equivalents include cash on hand and short-term, highly liquid investments with original maturities of three months or less that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

### **(d) Property and Equipment**

#### *i) Oil and Natural Gas Properties*

The Corporation follows the full cost method of accounting, whereby all costs associated with the exploration for and development of oil and natural gas reserves, whether productive or unproductive, are capitalized in cost centres on a country-by-country basis. Such costs include leasehold acquisition, drilling, completion, facility, pipeline, geological & geophysical costs, rentals on non-producing leases and administrative expenses related to exploration and development activities. Gains or losses are not recognized upon disposition of oil and natural gas properties unless crediting the proceeds against accumulated costs would result in a change in the rate of depletion of 20% or more.

The accumulated costs, less the costs of unproved properties, are depleted and amortized using the unit-of-production method based on total proved reserves as determined by independent evaluators. For purposes of the depletion and amortization calculations, net oil and natural gas reserves are converted to a common unit of measure (one thousand cubic feet of natural gas or "MCF") on the basis of their relative energy content.

The costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. These properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of impairment is added to the costs subject to depletion.

Net capitalized costs of the Corporation's oil and natural gas properties are subject to an annual Ceiling Test to ensure that capitalized costs do not exceed an estimate of future net revenues. This latter amount is the aggregate of expected undiscounted future net cash flows from proved reserves and costs of unproven properties. Future cash flows are estimated using expected future prices and costs. If the carrying amount is assessed to be not fully recoverable, the cost centre is written down to its fair value. The fair value is determined by the lesser of current market value or the estimated present value of expected future cash flows using forecast prices, from proved and probable reserves and the value of unproved properties. The impairment in the carrying amount of proved oil and natural gas properties would be recognized and charged to current operations as additional depletion.

The Reserve Report for the United States was prepared by Schlumberger Data and Consulting Services utilizing forecasted gas prices at the Henry Hub as published by McDaniel & Associates Consultants Ltd. The Reserve Report for Yemen was prepared by McDaniel & Associates Consultants Ltd. utilizing their published forecasted oil prices for Brent Crude. The commodity prices covering oil and natural gas for the first five years within the reserve reports utilized for the Ceiling Test follows:

	<b>Commodity Pricing</b>	
	<b>Oil (\$/Bbl)</b>	<b>Gas (\$/Mmbtu)</b>
<b>United States:</b>		
2009 .....	\$ 60.00	\$ 7.25
2010 .....	\$ 71.40	\$ 7.75
2011 .....	\$ 83.20	\$ 8.60
2012 .....	\$ 90.20	\$ 9.35
2013 .....	\$ 97.40	\$ 10.10
<b>Yemen:</b>		
2009 .....	\$ 58.00	\$ -
2010 .....	\$ 69.39	\$ -
2011 .....	\$ 81.08	\$ -
2012 .....	\$ 88.07	\$ -
2013 .....	\$ 95.26	\$ -

**ii) Office Equipment**

Amortization of office equipment is determined using the straight-line amortization method. The assets are split into four classifications, and have the following associated useful lives:

<b>Asset Category:</b>	<b>Useful Life</b>
Software .....	3 years
Vehicles .....	3 years
Hardware.....	5 years
Furniture & Fixtures .....	7 years

**(e) Deferred Pre-Operating Costs**

The Corporation capitalizes pre-operating costs pertaining to the start-up of operations in a new geographical area as deferred charges in accordance with Accounting Guideline AG-11 “Enterprises in the Development Stage” and the Emerging Issues Committee EIC-27 “Revenues and Expenditures During the Pre-Operating Period”. The deferred pre-operating costs are then amortized over a period of twelve months following the commencement of operations.

**(f) Asset Retirement Obligations (“ARO”)**

The Corporation recognizes the fair value of its ARO liabilities associated with tangible properties in the period in which the liability arises and when reasonable estimates of this fair value can be made. The fair value of this liability is calculated as the present value of the expected future costs of abandonment of such property. The liability is recorded as a long-term liability with a corresponding increase to the carrying amount of the related asset. The liability is increased each reporting period through the accretion of interest up to the future amount of the liability. The accretion is recorded as an expense in the Corporation’s financial statements. The addition to the carrying amount of the asset is depleted on the same basis as the corresponding asset. Revisions to the estimated amount or timing of the obligations are reflected as increases or decreases to the recorded liability and related asset. Actual costs incurred upon settlement of the abandonment obligation are charged against the liability as incurred.

In certain instances in North America, the Corporation pre-pays its ARO to the operator of its jointly held properties. In those instances, the amount paid for the ARO is capitalized and included in the depletable cost pool. The Corporation has no ARO liability for its properties located in Yemen, as those costs are cost recoverable and ultimately paid by the government of Yemen.

### **(g) Leases**

Leases are classified as capital or operating leases. Leases which transfer substantially all of the benefits and risks of ownership of property are accounted for as capital leases. Assets acquired under capital leases are amortized over the estimated useful lives of the underlying assets. All other leases are accounted for as operating leases and the related lease payments are charged to expense as incurred.

### **(h) Revenue Recognition**

Revenues from the sale of crude oil, natural gas and other petroleum products are recognized when the title passes to the purchaser and collectability is assured. Natural gas gathering fees, which are classified as “other revenues”, are recognized in the production month that natural gas is delivered for sale and the natural gas gathering fee is earned.

### **(i) Income Taxes**

The Corporation accounts for and measures future income tax assets and liabilities in accordance with the asset and liability method. Under this method, future income tax assets and liabilities are recognized for estimated tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Future income tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in income tax rates on future tax liabilities and assets is recognized in income in the period that includes the date of enactment or substantive enactment of the change. When the future realization of income tax assets is not more than likely not to occur, a valuation allowance in the amount of the potential benefit is taken.

### **(j) Stock Based Compensation**

The Corporation estimated the fair value of all stock options awarded to employees and directors using the Black-Scholes option pricing model. Compensation expense and a corresponding increase to contributed surplus are recorded over the vesting period based on the fair value of the options granted. When stock options are exercised for common shares, consideration paid by the stock option holders and contributed surplus associated with the stock options are recorded as share capital. If stock or stock options are repurchased, the excess of the consideration paid over the carrying amount of the stock or stock option cancelled is charged to retained earnings.

The Corporation records compensation expense for stock granted for services rendered by certain officers of the Corporation in lieu of cash. The fair value of such grants is determined based on the Black-Scholes option pricing model.

### **(k) Measurement Uncertainty**

The preparation of the consolidated financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates that affect reported amounts of assets and liabilities, the disclosure of any contingent assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenues and expenses during the reported periods. By their nature, these estimates, including those related to future cash flows, are subject to measurement uncertainty and the impact on the current and future consolidated financial statements resulting from changes in such estimates could be significant. Due to the use of estimates, actual results could differ significantly from those reported. Management believes the estimates used within the consolidated financial statements are reasonable as of the date of these consolidated financial statements.

The amounts recorded for depletion and amortization of property and equipment, stock based compensation, stock options, warrants, income taxes, asset retirement obligations, and other accruals are based on estimates. The Ceiling Test is based on estimates of oil and natural gas reserves, production rates, oil and natural gas prices, future costs and other relevant assumptions. Stock

compensation, stock options, and warrants are valued using the Black-Scholes option pricing model that includes assumptions that contain measurement uncertainty. The valuation allowance for income taxes is subject to measurement uncertainty pertaining to projecting future production levels, future capital expenditures, future commodity prices and future operating costs, all of which could vary significantly from actual results. Asset retirement obligations contain plugging and abandonment estimates, productive well life estimates, and other factors for which actual results may vary significantly from original estimates.

When estimating oil and natural gas reserves and their associated net cash flows, there are numerous factors that contain significant measurement uncertainties that are beyond the Corporation's control. Those factors include, but are not limited to, volumetric reserve estimates, future commodity pricing, future operating costs and the timing of and amount of future capital costs. When assessing the fair market value of reserves, additional factors must be considered such as current market conditions, credit markets, location of reserves, classification of reserves based on risk of recovery, political risk and other factors, all of which may contribute to significant measurement uncertainty. Due to the complexity involved, reserve estimates and fair market value estimates will vary greatly from one party to another.

#### **(l) Joint Ventures**

Some of the Corporation's oil and natural gas exploration, development and production activities are conducted jointly with others and, accordingly, these consolidated financial statements reflect only the Corporation's proportionate interest in such activities. The Corporation has entered into Joint Operating Agreements with its partners in each of its joint ventures. Terms of each Joint Operating Agreement include provisions whereby there is several, but not joint or collective liability for all parties to the Joint Operating Agreement.

#### **(m) Earnings per Share**

Basic net income (loss) per share is calculated using the weighted average number of shares outstanding. Diluted earnings (loss) per share is calculated using the treasury stock method. The treasury stock method assumes that any proceeds from the exercise of dilutive stock options and warrants would be used to repurchase common shares at the average market price during the period, with the incremental number of shares being included in the denominator of the diluted loss per share calculation, except when anti-dilutive.

#### **(n) Foreign Exchange Gains and Losses**

The Corporation translates the accounts of its Canadian parent company to US dollars by using the current rate method whereby all assets and liabilities are translated at the rates of exchange at the balance sheet dates, and revenues and expenses are translated at the average rates of exchange during the month in which they are recognized. Resulting gains or losses are included in the Consolidated Statements of Comprehensive Income (Loss) and in Shareholders' Equity as other comprehensive income.

Through December 31, 2008, substantially all of the Corporation's activities in Yemen were conducted in US dollars. The Corporation anticipates that substantially all of its future operations in Yemen will also be conducted in US dollars.

#### **(o) Financial Instruments**

All financial instruments are initially recognized at fair value on the balance sheet. The Corporation has classified each financial instrument into one of the following categories: (1) held for-trading (assets and liabilities), (2) loans and receivables, (3) financial assets available-for-sale, (4) financial assets held-to-maturity, and (5) other financial liabilities. Subsequent measurement of financial instruments is based on their classification.

Financial assets and liabilities “held-for-trading” are subsequently measured at fair value with changes in those fair values recognized in net earnings. Financial assets “available-for-sale” are subsequently measured at fair value with changes in fair value recognized in other comprehensive income, net of tax.

Financial assets “held-to-maturity”, “loans and receivables”, and “other financial liabilities” are subsequently measured at amortized cost using the effective interest method.

Cash and cash equivalents are classified as “available-for-sale”. Accounts receivable are classified as “loans and receivables”. Accounts payable and accrued liabilities are designated as “other financial liabilities”. Restricted cash is classified as “available-for-sale”.

The Corporation’s financial assets and liabilities are recorded and measured as follows:

<u>Asset or Liability</u>	<u>Category</u>	<u>Measurement</u>
Cash and cash equivalents .....	Available-for-sale	Fair value
Accounts receivables .....	Loans and receivables	Amortized cost
Current portion of notes payable .....	Other liabilities	Amortized cost
Restricted cash .....	Available-for-sale	Fair value
Accounts payables and accrued liabilities ...	Other liabilities	Amortized cost
Notes payable .....	Other liabilities	Amortized cost

Other balance sheet accounts, such as pre-paid expenses, property and equipment, deferred charges, and asset retirement obligations are not within the scope of the new accounting standards, as they are not financial instruments.

### 3. Accounting Pronouncements

#### (a) Accounting Changes

The Corporation has adopted CICA section 1506 of the CICA Handbook, “Accounting Changes”, as of January 1, 2007. The major impact of this section is to provide disclosure required when an entity has not applied a new source of GAAP that has been issued, but is not yet effective.

#### (b) Comprehensive Income and Equity

The Corporation has adopted CICA section 1530 of the CICA Handbook, “Comprehensive Income” and CICA section 3251 “Equity” of the CICA Handbook effective January 1, 2007.

#### (c) Financial Instruments – Recognition and Measurement; Disclosure and Presentation

The Corporation has adopted section 3855 of the CICA Handbook, “Financial Instruments – Recognition and Measurement” effective January 1, 2007. It describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. This section requires that:

- all financial assets be measured at fair value, with some exceptions such as loans and investments that are classified as held to maturity;
- all financial liabilities be measured at fair value if they are derivatives or classified as held for trading purposes. Other financial liabilities are measured at their amortized cost; and
- all derivative financial instruments are measured at fair value, even when they are part of a hedging relationship.

Effective January 1, 2008, the Corporation adopted CICA section 3862 of the CICA Handbook “Financial Instruments Disclosures” which, along with CICA section 3863 of the CICA Handbook “Financial Instruments Presentation” replaced CICA section 3861 of the CICA Handbook “Financial Instruments Disclosure and Presentation”. The new disclosure standard increases the emphasis on the

risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentation requirements. These standards did not have a significant impact on the Corporation's consolidated financial statements.

**(d) Capital Disclosures**

On January 1, 2008, the Corporation adopted section 1535 of the CICA Handbook "*Capital Disclosures*". This section established standards for disclosing information about an entity's capital and how it is managed to enable users of financial statements to evaluate the entity's objectives, policies and procedures for managing capital. This information is provided in Note 20 "*Capital Disclosures*".

**(e) Future Accounting Pronouncements**

*Goodwill and Intangible Assets*

In February 2008, the CICA issued section 3064 of the CICA Handbook "*Goodwill and Intangible Assets*", which replaces section 3062 of the CICA Handbook "*Goodwill and Other Intangible Assets*" and section 3450 of the CICA Handbook "*Research and Development Costs*". These new sections of the CICA Handbook will be applicable to fiscal years beginning on or after October 31, 2008 and establish standards for recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous section 3062. This new standard is not expected to have a material effect on the Corporation's consolidated financial statements.

*Business Combinations*

Section 1582 "*Business Combinations*" will provide the Canadian equivalent to International Financial Reporting Standard IFRS 3, "*Business Combinations*" and replace the existing Section 1581 "*Business Combinations*". The new Section 1582 "*Business Combinations*" will apply prospectively to business combinations for which the acquisition date is on or after January 1, 2011. Earlier adoption is permitted as of the beginning of a fiscal year, in which case an entity would also early adopt Section 1601 "*Consolidated Financial Statements*" and Section 1602 "*Non-controlling Interests*".

*Consolidated Financial Statements*

Effective January 1, 2011, Section 1601 "*Consolidated Financial Statements*" establishes standards for the preparation of consolidated financial statements and will replace the existing Section 1600 "*Consolidated Financial Statements*". Earlier adoption is permitted as of the beginning of a fiscal year, in which case an entity would also early adopt Section 1582 "*Business Combinations*" and Section 1602 "*Non-Controlling Interests*".

*Non-Controlling Interests*

Effective January 1, 2011, Section 1602 "*Non-Controlling Interests*" establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27 "*Consolidated and Separate Financial Statements*". Earlier adoption is permitted as of the beginning of a fiscal year, in which case an entity would also early adopt Section 1582 "*Business Combinations*" and Section 1601 "*Consolidated Financial Statements*".

*International Financial Reporting Standards*

In March 2007, the CICA announced that Canadian publicly accountable enterprises will adopt International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") effective January 1, 2011. IFRS will require increased financial statement disclosure. Although IFRS uses conceptual framework similar to GAAP, differences in accounting policies will need to be addressed. The Corporation is currently assessing the impact IFRS, including possible exemption relief, and the effect IFRS will have on its consolidated financial statements.

The Corporation is currently evaluating the impact of the adoption of the above new accounting standards on its consolidated financial statements.

#### 4. Accounts Receivable

The Corporation's Accounts Receivable balances as at December 31, 2008 and 2007, respectively, were comprised of the following:

	<b>As at December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Accounts Receivable:</b>		
Joint interest – OGMC .....	\$ 5,590,881	\$ -
Joint interest – North America .....	379,004	72,365
Oil and natural gas revenues .....	1,169,222	502,541
Total .....	<u>\$ 7,139,107</u>	<u>\$ 574,906</u>

As of December 31, 2008, the Corporation had outstanding joint interest receivables from Oil and Gas Mine Company of \$5,590,881 for their pro-rata share of costs pertaining to Block 41. See Note 21 "Subsequent Events – Oil and Gas Mine Company Default".

#### 5. Notes Receivable

At December 31, 2008, the Corporation had outstanding notes receivable of \$359,401 (originally issued for CDN\$439,205) bearing no interest and due on September 9, 2009 from a private Canadian company. The note receivable was issued as part of the Corporation's commitment to drill two horizontal wells to earn an interest in a certain Area of Mutual Interest ("AMI") in prospective Bakken shale in the Province of Saskatchewan. See Note 14 "Commitments and Contingencies – Bakken Shale Drilling Commitment".

#### 6. Investments

At December 31, 2008, the Corporation had an investment of CDN\$1.0 million (US dollar equivalent of \$818,300) in a convertible debenture that was in default with Peace River Oil Inc., a privately held Alberta corporation engaged primarily in constructing an oil refinery and exploring for oil within the Province of Alberta. The Corporation wrote off the entire balance of the convertible debenture during 2007 after Peace River Oil Inc. defaulted and the Corporation elected not to convert the convertible debenture into 2% of the then outstanding shares of Peace River Oil Inc. The convertible debenture was for a twelve month term at an interest rate of 9% payable semi-annually and secured by Peace River Oil Inc.'s plant, property and equipment. Additional terms included granting the Corporation an exclusive right to explore for natural gas on all unproved acreage then currently held or subsequently acquired in the future by Peace River Oil Inc. As at December 31, 2008, Peace River Oil Inc. had unproved acreage covering approximately 9,000 acres in the Peace River area which had, in management's opinion, nominal value.

The Corporation has taken steps to enforce its security granted in Peace River Oil Inc.'s assets pursuant to terms of the convertible debenture and is evaluating whether the sale of such assets will cover the outstanding principal and interest due to the Corporation. The Corporation has also determined there are additional liens on the collateralized assets filed by contractors that are ahead of the Corporation's lien position. Peace River Oil Inc. has attempted to obtain additional financing, sell certain assets, and renegotiate terms of the convertible debenture, all of which failed. As a result, in management's opinion, it is highly unlikely that the Peace River Oil Inc. convertible debenture will be re-paid. As such, the Corporation recorded an impairment charge of \$1,115,419, including principal and accrued interest for the period ended December 31, 2007.

## 7. Property and Equipment

The following table summarizes the Corporation's oil and natural gas property and other equipment as at December 31, 2008 and 2007, respectively:

	<u>Gross Cost</u>	<u>Accumulated Depletion, Depreciation and Amortization</u>	<u>Net Book Value</u>
<b>As at December 31, 2008:</b>			
Oil and natural gas properties..	\$ 121,514,574	\$ 37,518,982	\$ 83,995,592
Office equipment:			
Software .....	95,753	38,608	57,145
Hardware .....	127,590	35,220	92,370
Furniture & Fixtures, Vehicles and other .....	272,403	64,025	208,378
Total .....	<u>\$ 122,010,320</u>	<u>\$ 37,656,835</u>	<u>\$ 84,353,485</u>
<b>As at December 31, 2007:</b>			
Oil and natural gas properties..	\$ 69,067,704	\$ 1,467,861	\$ 67,599,843
Office equipment:			
Software .....	41,181	15,959	25,222
Hardware .....	48,855	9,715	39,140
Furniture & Fixtures .....	60,081	6,200	53,881
Total .....	<u>\$ 69,217,821</u>	<u>\$ 1,499,735</u>	<u>\$ 67,718,086</u>

The following table summarizes the gross capitalized oil and natural gas property costs incurred by project area during the periods ended December 31, 2008 and 2007, respectively:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Oil and Natural Gas Properties:</b>		
Beginning of year balance .....	\$ 69,067,704	\$ 13,992,058
<b>Leasehold and Seismic:</b>		
Middle East and Africa:		
Yemen <sup>(1)</sup> .....	5,419,052	32,190,357
Ethiopia.....	1,851,114	-
Other <sup>(1)</sup> .....	450,718	-
Total Middle East and Africa.....	<u>7,720,884</u>	<u>32,190,357</u>
United States:		
Pennsylvania.....	2,653,970	1,333,630
New York .....	4,362,433	798,682
West Virginia <sup>(2)</sup> .....	99,170	1,152,843
Ohio <sup>(2)</sup> .....	(1,410,512)	779,654
Other <sup>(3)</sup> .....	1,009	32,126
Total United States .....	<u>5,706,070</u>	<u>4,096,935</u>
Canada:		
Quebec <sup>(5)</sup> .....	-	65,813
Saskatchewan.....	534,638	-
Total Canada.....	<u>534,638</u>	<u>65,813</u>
Total leasehold acquisition .....	<u>13,961,592</u>	<u>36,353,105</u>
<b>Drilling, Completion and Facility:</b>		
Middle East and Africa:		
Yemen.....	9,706,920	-
Total Middle East and Africa.....	<u>9,706,920</u>	-
United States: <sup>(4)</sup>		
Pennsylvania.....	18,958,528	1,433,943
New York .....	1,688,516	1,187,067
West Virginia <sup>(5)</sup> .....	7,793,217	16,081,974
Ohio .....	338,097	19,557
Total United States .....	<u>28,778,358</u>	<u>18,722,541</u>
Total drilling, completion and facility ..	<u>38,485,278</u>	<u>18,722,541</u>
<b>Total Additions for the Year</b> .....	52,446,870	55,075,646
<b>End of Year Balance</b> .....	<u>\$ 121,514,574</u>	<u>\$ 69,067,704</u>

Notes:

- (1) At December 31, 2008, the Corporation recognized unproved property impairments totaling \$34,099,133 (comprising \$34,071,330 for Yemen and \$27,803 relating primarily to Qatar). See Note 7 "Property and Equipment – Unproved Property Impairment".
- (2) 2008 amounts are net of costs associated with the sale of leasehold interests. See Note 7 "Property and Equipment – Unproved Property Divestitures".
- (3) The Corporation recognized inception to year-end abandonment costs pertaining to unproved properties of \$239,681 and \$231,639 at December 31, 2008 and 2007, respectively, which were added to the amortization base for its United States proved properties.
- (4) Includes inception to year-end non-cash Asset Retirement Obligation amounts of \$334,757 and \$194,776 at December 31, 2008 and 2007, respectively, exclusive of accretion. See Note 11 "Asset Retirement Obligations".

- (5) As at December 31, 2007 amounts are reflected net of Gastem Inc.'s 25% working interest covering participation in certain wells at a total cost of \$1.05 million to Gastem, Inc. See Note 7 "Property and Equipment – West Virginia" and Note 7 "Property and Equipment – Quebec". Amounts are also net of \$220,000 received from Alder Resources Ltd. for their 15% working interest obtained in seven wells. See Note 7 "Property and Equipment – West Virginia".

### ***Cost Center Categorization***

As at December 31, 2008, the Corporation had gross oil and natural gas property costs of \$121,514,574, including \$47,316,330 in Yemen, \$1,851,114 in Ethiopia, \$71,295,961 in the United States, \$600,451 in Canada and \$450,718 in other miscellaneous international areas. As at December 31, 2007, the Corporation had gross oil and natural gas property costs of \$69,067,704, including \$32,190,357 in Yemen, \$36,811,534 in the United States, and \$65,813 in Canada. Only the United States oil and natural gas properties were subject to depletion during 2008 and 2007. As at December 31, 2008 and 2007, the United States capitalized oil and natural gas properties classified as unproved and not subject to depletion totaled \$11,181,674 and \$10,571,037, respectively. As at December 31, 2008 and 2007, \$754,338 of capitalized costs pertaining to Yemen was classified as proved, and \$12,490,662 and \$31,436,019 of costs were classified as unproved at December 31, 2008 and 2007, respectively. Yemen proved property costs applied to a shut-in well that had no production during 2008 and 2007. As at December 31, 2008 and 2007, all capitalized costs associated with the Corporation's properties in Ethiopia, Canada and other miscellaneous international areas were categorized as unproved.

### ***Capitalized General and Administrative Costs ("G&A")***

The Corporation had cumulative capitalized G&A costs of \$1,862,718 and \$535,197 at December 31, 2008 and 2007, respectively. Capitalized G&A costs at December 31, 2008 included \$1,039,773 for the United States and \$822,945 for Yemen. All of the cumulative capitalized G&A costs as of December 31, 2007 related to the United States.

### ***Unproved Property Impairment***

On December 31, 2008, the Corporation assessed the carrying value of its unproved properties on Block 41 in Yemen and determined that such costs were partially impaired. At December 31, 2008, the Corporation recorded an unproved property impairment of \$34,071,330 covering its interests on Block 41 in Yemen. Management's assessment of the fair value of its unproved property costs for Block 41 at December 31, 2008 was approximately \$12.5 million. The valuation of oil and gas reserves contains significant measurement uncertainty, including such factors as market conditions, credit markets, category of oil and natural gas reserves, the location of oil and natural gas reserves and assumptions used to calculate the volumes of commercially producible oil and natural gas reserves and the resulting cash flows from such production. See Note 2 (k) "Measurement Uncertainty". In addition, the Corporation impaired \$27,803, relating primarily to Qatar, where it has no further exploration plans.

### ***Unproved Property Divestitures***

During 2008, the Corporation divested itself of the following non-core properties located in the Appalachian Basin in the United States:

	<u>Sales Price</u>	<u>Cost Basis</u>	<u>Gain or (Loss)</u>
West Virginia: Ben Gay .....	\$ 125,841	\$ 126,480	\$ (639)
Ohio: Swan Creek and Bootleg ...	6,642,184	1,628,416	5,013,768
Total	<u>\$ 6,768,025</u>	<u>\$ 1,754,896</u>	<u>\$ 5,013,129</u>

## ***Description of Properties by Geographical Area***

### ***Middle East***

#### ***Yemen***

On September 10, 2007, the Corporation signed a Farm-in Agreement with Oil and Gas Mine Company, a privately owned Cayman Islands corporation operating in Yemen, to acquire a 57.14% paying interest and 50% undivided percentage interest in the rights, duties, interests and obligations under the Block 41 Production Sharing Agreement (“Block 41 Participating Interest”), which covers oil and natural gas exploration and production rights to approximately 1.4 million gross acres located onshore in Yemen. As at December 31, 2008, the Corporation had capitalized oil and natural gas property costs of \$47,316,330 (before unproved property impairment of \$34,071,330) pertaining to Block 41, including \$36,609,410 of leasehold costs and \$9,706,920 of drilling costs pertaining to drilling 3 gross (1.71 net) wells during 2008. See Note 7 “*Property and Equipment – Unproved Property Impairment*”.

### ***Africa***

#### ***Ethiopia***

On June 12, 2008, the Corporation entered into an exclusive Study Agreement, referred to as the Northwest Area Study Agreement, with the Ministry of Mines and Energy in Ethiopia. The Northwest Area Study Agreement covers 154,871.53 square kilometers (96,232.7 square miles) in the northwestern sector of the country for an initial one year term. Upon completion of the Northwest Area Study Agreement, the Corporation has an exclusive right to negotiate an agreement or agreements to further explore for oil and natural gas on any or all of the land covered by the Northwest Area Study Agreement by obtaining an oil and natural gas concession or concessions from the Ministry of Mines. Through December 31, 2008, the Corporation had incurred \$1,851,114 under the terms of this agreement.

### ***United States***

#### ***Pennsylvania***

In Pennsylvania, through December 31, 2008, the Corporation had acquired 15,403 gross (15,184) net leasehold acres and drilled 7 wells (gross and net) covering the Marcellus shale formation. The Corporation is the operator and owns a 100% working interest in its Pennsylvania properties. Initial natural gas production from Pennsylvania is expected to occur during 2009.

#### ***New York***

In New York, through December 31, 2008, the Corporation had acquired 32,618 gross (15,947 net) leasehold acres. Also, as an integrated participating owner, the Corporation had participated in drilling 25 gross (0.80 net) wells, including 6 gross (.28 net) producing wells, 14 gross (0.42 net) exploratory dry holes and 5 gross (0.10 net) wells that were shut-in pending further evaluation. As a non-participating owner, the Corporation had participated in 7 gross (0.10 net) wells, of which 3 gross (0.06 net) had paid out and were producing. The Corporation’s New York acreage is governed by a Joint Operating Agreement dated August 8, 2005 between the Corporation, Southwestern Oil Company and Austin Exploration LLC naming the Corporation as operator. The Corporation’s revenues and costs exclude any related party’s (Austin Exploration LLC) share. The Corporation’s interest in wells to date has been primarily as a non-operator with a small minority working interest covering wells drilled in the Trenton-Black River formation. See Note 14 “*Commitments and Contingencies*” and Note 17 “*Related Party Transactions*”.

#### ***West Virginia***

In West Virginia, through December 31, 2008, the Corporation had acquired 36,474 gross (14,668 net) leasehold acres and drilled 111 gross (58.96 net) wells, including 108 gross (57.56 net) wells that were

producing and 3 gross (1.40 net) wells that were shut-in waiting on pipeline connection. The Corporation's West Virginian interests are governed by a Joint Operating Agreement dated March 6, 2006 between the Corporation and its joint venture partners, primarily Hard Rock Exploration Inc. and Carter Oil & Gas Inc. Hard Rock Exploration Inc. is the operator. The Corporation's working interests vary from approximately 50% to 63%.

On February 7, 2007 the Corporation granted Gastem Inc. the right to participate in 25% of the Corporation's interest in future wells to be drilled in the Corporation's Amber Bank project by spending up to \$1.05 million. Gastem Inc. participated in 24 gross (6.0 net) wells in the Amber Bank project under this agreement and met its \$1.05 million financial commitment during April 2007. See Note 17 "*Related Party Transactions*".

On January 14, 2008, the Corporation entered into an Agreement with Alder Resources Ltd. ("Alder"), whereby Alder agreed to pay the Corporation \$220,000 cash plus 15% of the pro-rata share to drill seven specific wells in West Virginia in return for 15% of the gross working interest in the same seven specific wells. Due to the immaterial nature of the transaction, no gain or loss was recognized on the transaction and the cash proceeds were applied as a reduction to the Corporation's carrying costs for each specific well.

### ***Ohio***

In Ohio, through December 31, 2008, the Corporation had acquired 40,155 gross (8,840 net) leasehold acres and drilled 3 gross (0.8 net) wells in the Bailey's Mill project that were producing gas on an intermittent basis. The Corporation's Ohio interests consist of the Bailey's Mill project, which is operated by Phillips Production Company under terms of a Joint Operating Agreement dated April 1, 2006 between the Corporation and EOG Resources Inc., for which the Corporation has a 25% working interest.

### ***Canada***

#### ***Saskatchewan Province***

On August 28, 2008, the Corporation entered into an agreement with a private Canadian company covering joint oil and natural gas exploration and development activities in a 63,360 gross acre Area of Mutual Interest ("AMI") covering the Bakken oil play in southeast Saskatchewan province.

Under the terms of the agreement the Corporation has the right to earn a 50% interest in approximately 8,960 gross (7,806 net) acres within the AMI. The private Canadian company will be the operator of the AMI.

#### ***Quebec Province***

On February 7, 2007, the Corporation acquired a 25% undivided participating interest in Gastem Inc.'s undeveloped oil and natural gas interests covering approximately 1,184,000 gross (249,000 net) leasehold acres in the St. Lawrence Lowlands and in the Gaspé Peninsula of Quebec. Under terms of the Agreement, the Corporation may elect to participate, on a well-by-well basis, for up to 25% of Gastem Inc.'s working interest in any current or future properties Gastem Inc. may acquire in Quebec. In return, the Corporation granted Gastem Inc. the right to participate in 25% of the Corporation's interest in future wells to be drilled in the Amber Bank project (17,800 gross acres, 8,960 net acres) in West Virginia by spending \$1.05 million to participate in the drilling of 24 gross (6.0 net) wells. The Corporation's carrying value of its Amber Bank project's leasehold attributable to Gastem Inc.'s participation was nominal. The agreement was consummated with the expectation that Raymond Savoie, Gastem Inc.'s President, would become a director of the Corporation. Mr. Savoie became a director of the Corporation on July 16, 2007. See Note 17 "*Related Party Transactions*".

## 8. Current Liabilities

The Corporation's accounts payable and accrued liability balances were comprised of the following:

	<b>As at December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Current Liabilities:</b>		
Trade payables .....	\$ 3,936,611	\$ 1,058,615
Accrued liabilities – oil and natural gas properties .....	6,796,440	6,646,932
Other accrued liabilities .....	3,903,417	1,796,610
Total .....	<u>\$ 14,636,468</u>	<u>\$ 9,502,157</u>

## 9. Loan Facilities and Letter of Credit

### *Loan Facilities*

At December 31, 2008, the Corporation had two credit lines in place totaling \$26,000,000 and had utilized \$19,184,134 of credit that was then available, including \$9,204,500 at Northwestern Bank and \$9,979,634 at TD Bank. A discussion of each loan facility follows:

- *Northwestern Bank, Traverse City, Michigan:* USD\$11,000,000, secured by a lien on the Corporation's New York assets in the amount of \$10,000,000 and a \$1,000,000 minimum deposit at Northwestern Bank. Terms of the credit line include an interest rate of prime less 1/4 percent. As at December 31, 2008, the Corporation had an outstanding amount of \$9,204,500 under the terms of this credit line, leaving \$1,795,500 of available unused credit.
- *TD Bank, Toronto, Canada:* USD\$15,000,000, secured by Canadian dollar equivalent of 115% of the borrowed amount. At December 31, 2008, the amount of restricted cash and cash equivalents by TD Bank was based on full utilization of the credit line coupled with a reserve for currency fluctuations. Terms of the credit line include an interest rate of prime plus 0.5%. As at December 31, 2008, the Corporation had an outstanding amount of \$9,979,634 under the terms of this credit line, leaving \$5,020,366 of available unused credit.

During 2008, the Corporation utilized its credit lines primarily to manage foreign currency translation volatility resulting from the United States financial crisis that developed during the latter half of 2008. During that time, the foreign currency translation rate changed from approximately 1.0 per Canadian dollar to U.S. dollar to approximately 0.80 per Canadian dollar to U.S. dollar. Prior to the United States financial crisis, the Corporation held a substantial amount of its cash, cash equivalents and short term investments in Canadian dollars.

### *Letter of Credit - Yemen*

Under terms of the Block 41 Production Sharing Agreement ("Block 41PSA"), as operator the Corporation must post a letter of credit in favor of the Ministry of Minerals covering the gross amount of expected expenditures during each calendar year. During 2008, the Corporation initially posted a \$16,000,000 letter of credit secured by \$17,600,000 of restricted cash deposits at TD Bank. The letter of credit was subsequently reduced as documented details pertaining to the work program on Block 41 were presented to the Ministry of Minerals by the Corporation. At December 31, 2008, the balance of that letter of credit had been reduced to \$8,000,000, which was secured by restricted cash of \$11,375,064.

### Restricted Cash

At December 31, 2008, the Corporation's restricted cash balances consisted of the following:

	<u>December 31,</u> <u>2008</u>
<b>Restricted Cash:</b>	
Northwestern Bank – loan facility .....	\$ 1,000,000
TD Bank – loan facility .....	21,328,244
TD Bank – Yemen letter of credit .....	11,375,064
Total .....	<u>\$ 33,703,308</u>

## 10. Notes Payable

At December 31 2008, the Corporation's notes payable were \$34,573, including \$15,574 classified as current and \$18,999 classified as long-term. The principal amounts due cover the purchase of a copier and a vehicle, both of which were purchased during 2008. The Corporation had no outstanding notes payable at December 31, 2007.

## 11. Asset Retirement Obligations ("ARO")

The total future asset retirement obligation was estimated based on the Corporation's net ownership interest in all wells and facilities in the Appalachian basin in the United States and includes estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. No provision was made for asset retirement obligations with respect to the Corporation's Yemen properties, as the Corporation is not under a legal requirement pertaining to reclamation costs within Yemen.

The Corporation has estimated the net present value of its total asset retirement obligations for wells drilled on its projects in the Appalachian basin to be \$334,757 and \$194,777 at December 31, 2008 and 2007, respectively, based on estimated total undiscounted future liabilities of \$1,075,126 and \$524,558, respectively. These payments are expected to be made at the end of the associated properties economic life, which is estimated at approximately 65 years. The Corporation assumed an estimated credit adjusted risk-free rate of 4.25% and an estimated inflation rate of 2% to calculate the net present value of the asset retirement obligations.

During 2008 and 2007, respectively, the Corporation paid \$14,778 and \$18,622 to the operator of its West Virginia properties for its pro-rata share of a plugging and abandonment fund held by the operator. The Corporation offset such amounts against its previously recorded ARO liability. The Corporation's ARO balances at December 31, 2008 and 2007, respectively, were comprised of the following:

	<u>As at December 31,</u>	
	<u>2008</u>	<u>2007</u>
<b>Asset Retirement Obligations:</b>		
Balance, beginning of year.....	\$ 181,104	\$ 127,611
Reimbursement of pre-paid ARO .....	-	(88,786)
ARO additions .....	139,981	155,951
Contributions to plugging fund .....	(14,778)	(18,622)
Accretion.....	13,456	4,950
Balance, end of year.....	<u>\$ 319,763</u>	<u>\$ 181,104</u>

## 12. Income Taxes

### (a) Provision for Income Taxes

Major items causing the Corporation's income tax rate to differ from the Canadian rate of approximately 33.5% (2007 - 36%) for the years ended December 31, 2008 and 2007, respectively, are as follows:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Provision for Income Taxes:</b>		
Net income or (loss)		
before income taxes .....	\$ (31,087,916)	\$ (2,223,587)
Income tax benefit based on		
statutory rate .....	10,414,452	800,491
Stock based compensation .....	(618,584)	(500,247)
Excess depletion and amortization.....	4,087,809	1,579,561
Yemen impairment.....	(11,413,895)	-
Other non-deductible losses.....	(973,780)	-
Share issuance deduction .....	531,490	410,678
Net loss carry-forwards.....	400,000	-
Difference in Canadian and		
US tax income tax rates .....	(492,017)	-
Valuation allowance.....	(4,535,475)	(2,290,483)
Income tax provision.....	<u>\$ 2,600,000</u>	<u>\$ -</u>

Due to the volatile nature of oil and natural gas exploration, development, and production activities, there are numerous uncertainties with respect to projecting future revenues and operating costs, which are integral components of future net income projections. These uncertainties include such items as production levels, capital expenditure levels, oil and natural gas commodity prices, reserve estimates, and lease operating costs. Actual results may vary significantly from projected amounts. The Corporation expects the future actual after tax effects of such amounts to range from zero to approximately \$3.5 million, which approximates the after tax amount of the Corporation's overall net operating loss carry-forward at December 31, 2008 in Canada and the United States. Accordingly, the Corporation has provided a 100% valuation allowance as per the above table.

In Yemen, the Corporation effectively has no income tax liability for activities pertaining to the Block 41 PSA. Under terms of the Block 41 PSA, the government owned oil company ("The Yemen Company" or "TYCO") pays all income taxes due from its share of crude oil revenue.

### (b) Future Tax Balances

The tax effects of temporary differences and losses that give rise to future income tax assets and liabilities for the years ended December 31, 2008 and 2007, respectively, are comprised of the following amounts:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Future Income Tax Assets:</b>		
Share issue costs .....	\$ 1,758,720	\$ 1,572,572
Non-capital losses .....	3,229,863	2,191,052
Temporary difference for		
property and equipment .....	(5,623,493)	(1,535,684)
Valuation allowance.....	(1,965,090)	(2,227,940)
Future income tax liability .....	<u>\$ 2,600,000</u>	<u>\$ -</u>

### (c) Tax Loss Carry-forwards

As at December 31, 2008, the Corporation had \$1,547,537 of non-capital losses in Canada and \$7,039,602 of non-capital losses in the United States, which under certain circumstances may be used to reduce taxable income of future years. These losses expire as follows:

	<u>Canada</u>	<u>United States</u>	<u>Total</u>
<b>Year of Expiration:</b>			
2015 .....	\$ 37,106	\$ -	\$ 37,106
2025 .....	-	183,300	183,300
2026 .....	-	16,746	16,746
2027 .....	69,170	4,189,528	4,258,698
2028 .....	1,441,261	2,650,028	4,091,289
Total .....	<u>\$ 1,547,537</u>	<u>\$ 7,039,602</u>	<u>\$ 8,587,139</u>

## 13. Shareholders' Equity

### (a) Authorized shares

The Corporation is authorized to issue an unlimited number of Common Shares with no par value and an unlimited number of Preferred Shares with no par value.

### (b) Issued

The following table summarizes the components of share capital for the years ended December 31, 2008 and 2007, respectively:

	<u>Number of Shares Issued</u>	<u>Amount</u>
<b>Balance at January 1, 2007</b> .....	20,043,900	\$ 20,028,270
Common stock delivered to officer.....	50,000	50,000
Private placements <sup>(1)</sup> .....	5,468,700	13,671,750
Issuance costs for private placements <sup>(1)</sup> .....	-	(559,908)
Warrants issued <sup>(1)</sup> .....	-	(11,269)
Exercise of stock options <sup>(2)</sup> .....	678,988	941,488
Exercise of stock options <sup>(2)</sup> .....	-	251,286
Initial public offering <sup>(3)</sup> .....	18,000,000	74,296,800
Issuance costs for initial public offering <sup>(3)</sup> .....	-	(4,942,481)
Common stock issued for property interest <sup>(4)</sup> .....	1,456,735	6,000,000
<b>Balance at December 31, 2007</b> .....	<u>45,698,323</u>	<u>\$ 109,725,936</u>
Warrants exercised <sup>(1)</sup> .....	17,000	42,500
Warrants exercised <sup>(1)</sup> .....	-	11,269
Shares issued for Bought Deal <sup>(5)</sup> .....	5,600,000	33,442,500
Issuance costs for Bought Deal <sup>(5)</sup> .....	-	(2,228,832)
Repurchase of Common Shares <sup>(6)</sup> .....	(1,000,000)	(2,734,114)
<b>Balance at December 31, 2008</b> .....	<u>50,315,323</u>	<u>\$ 138,259,259</u>

Notes:

- (1) During the first nine months of 2007, the Corporation completed two private placements by issuing 5,468,700 Common Shares. Each Common Share issued contained one penalty warrant per ten common shares purchased, to be issued in the event the Corporation was not a publicly trading enterprise by October 31, 2007. The Corporation became a publicly traded enterprise on October 24, 2007, effectively voiding

all penalty warrants associated with the aforementioned private placements. Warrants covering 17,000 Common Shares at an exercise price of \$2.50 per share and a term of 18 months from the date of closing were issued in connection with the first private placement completed during 2007. During June 2008, 17,000 warrants were exercised, resulting in no warrants outstanding at December 31, 2008.

- (2) During 2007, options covering 678,988 Common Shares were exercised at an average per Common Share price of \$1.39, resulting in net proceeds of \$941,488. Related amounts previously recorded in contributed surplus of \$251,286 were added to share capital pertaining to the stock options that were exercised.
- (3) The Corporation closed its Initial Public Offering on October 24, 2007 at a price of CDN\$4.00 per Common Share.
- (4) The Corporation issued 1,456,735 Common Shares valued at \$6,000,000 to the Oil and Gas Mine Company as part of the consideration due for the acquisition of the Block 41 Participating Interest.
- (5) On August 25, 2008, the Corporation sold 5,600,000 Common Shares at a price of \$5.97 (CDN\$6.25) per common share for gross proceeds of \$33,442,500 (CDN\$35,000,000). Terms included an Underwriter's over-allotment option of 15%, or 840,000 Common Shares, exercisable within thirty days of the closing date of the transaction. The over-allotment option was not exercised by the Underwriters.
- (6) Effective October 1, 2008, the Corporation obtained approval of a Notice of Intention to commence a normal course issuer bid through the facilities of the Toronto Stock Exchange, permitting the Corporation to repurchase, for cancellation, up to 2,000,000 of its Common Shares between October 1, 2008 and September 30, 2009. Prior to commencement of the Notice of Intention, the Corporation's average price per share of Common Shares issued was \$2.75 per Common Share. As of December 31, 2008, the Corporation had repurchased 1,000,000 of its Common Shares through this facility at an average price of \$0.69 per Common Share.

**(c) Stock Options**

The following table summarizes stock option activity for the years ended December 31, 2008 and 2007, respectively:

	<b>As at December 31,</b>			
	<b>2008</b>		<b>2007</b>	
	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
<b>Stock Options</b>				
<b>Outstanding:</b>				
Beginning of year .....	2,565,632	\$ 2.31	1,632,488	\$ 1.15
Granted .....	977,817	\$ 3.78	1,612,132	\$ 3.09
Exercised .....	-	-	(678,988)	\$ 1.39
Forfeited and expired .....	(226,000)	\$ 4.33	-	-
End of year .....	<u>3,317,449</u>	<u>\$ 2.60</u>	<u>2,565,632</u>	<u>\$ 2.31</u>
Exercisable at year-end ...	<u>1,836,166</u>	<u>\$ 1.81</u>	<u>1,089,634</u>	<u>\$ 1.84</u>

The following table summarizes information about stock options outstanding at December 31, 2008 and 2007, respectively:

<u>Exercise Price</u>	<u>Number of Options Outstanding</u>	<u>Number of Options Exercisable</u>	<u>Black-Scholes Option Pricing Model Valuation <sup>(1)</sup></u>	<u>Weighted Average Remaining Contractual Life (in years)</u>
<b>As at December 31, 2008:</b>				
\$ 0.85	315,317	-	\$ 29,206	4.95
\$ 1.00	856,000	856,000	557,768	6.88
\$ 2.00	347,500	314,167	320,576	2.94
\$ 2.50	621,132	547,999	896,742	6.84
\$ 4.00	865,000	118,000	1,003,418	9.10
\$ 5.34	100,000	-	65,301	9.67
\$ 5.60	50,000	-	42,850	9.63
\$ 6.10	162,500	-	220,181	9.45
	<u>3,317,449</u>	<u>1,836,166</u>	<u>\$ 3,136,042</u>	<u>7.11</u>
<b>As at December 31, 2007:</b>				
\$ 1.00	856,000	428,000	\$ 290,504	7.88
\$ 2.00	347,500	149,834	214,159	3.94
\$ 2.50	721,132	511,800	887,203	7.37
\$ 4.00	641,000	-	83,359	9.92
Total	<u>2,565,632</u>	<u>1,089,634</u>	<u>\$ 1,475,225</u>	<u>7.71</u>

Note:

(1) Amount equates to its applicable component of Contributed Surplus.

The fair value of each option granted was estimated on the date of grant using the Black-Scholes option pricing model assuming no dividend yield, expected life equal to the term of the option agreement, expected volatility of 50% before the Initial Public Offering, expected volatility of 84.47% after the Initial Public Offering, and a risk free interest rate of 4.25% for the years ended December 31, 2008 and 2007. Stock options containing vesting provisions contingent upon market capitalization valuations did not have any assignable value under the Black-Scholes option pricing model. The weighted average price per Common Share valuation using the Black-Scholes pricing option was \$2.65 and \$1.91 for the year ended December 31, 2008 and 2007, respectively.

**(d) Warrants**

The following table summarizes warrant activity for the years ended December 31, 2008 and 2007, respectively:

As at December 31,				
2008			2007	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
<b>Warrants Outstanding:</b>				
Beginning of year .....	17,000	\$ 2.50	300,000	\$ 0.32
Granted .....	-	-	17,000	2.50
Exercised .....	(17,000)	2.50	-	-
Expired .....	-	-	(300,000)	0.32
End of year .....	-	\$ 0.00	17,000	\$ 2.50
Exercisable at year-end..	-	\$ 0.00	17,000	\$ 2.50

There were no warrants outstanding at December 31, 2008. The following table summarizes information about warrants outstanding at December 31, 2007:

Exercise Price	Number of Warrants Outstanding	Number of Warrants Exercisable	Black-Scholes Option Pricing Model Valuation	Weighted Average Remaining Contractual Life (in years)
<b>December 31, 2007:</b>				
\$ 2.50	17,000	17,000	\$ 11,269	0.90
Total	17,000	17,000	\$ 11,269	0.90

The fair value of each warrant was estimated on the date of grant using the Black-Scholes option pricing model assuming no dividend yield, expected volatility of 50% and a risk free interest rate of 4.25% for the presented periods. Warrants granted during 2007 were calculated to have a fair value of \$0.66 per Common Share and were issued in the same series. Warrants outstanding as of the beginning of 2007 were originally issued in the same series during 2006 and were calculated to have a fair value of \$0.12 per share. All of those warrants expired on May 10, 2007.

**(e) Contributed Surplus**

The following table summarizes contributed surplus for the years ended December 31, 2008 and 2007 respectively:

	Year Ended December 31,	
	2008	2007
<b>Contributed surplus:</b>		
Balance, beginning of year .....	\$ 1,512,133	\$ 336,935
Valuation of re-purchase of Common Shares .....	2,042,710	-
Stock options granted .....	1,846,518	1,389,576
Stock options exercised .....	-	(251,286)
Warrants expired .....	-	36,908
Balance, end of year .....	\$ 5,401,361	\$ 1,512,133

***(f) Stock Based Compensation***

Stock based compensation for the years ended December 31, 2008 and 2007, respectively, were comprised of the following:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Stock Based Compensation:</b>		
Stock option amortization .....	\$ 1,846,518	\$ 1,389,576
Total stock based compensation.....	<u>\$ 1,846,518</u>	<u>\$ 1,389,576</u>

***(g) Accumulated Other Comprehensive Income (Loss)***

Accumulated other comprehensive income (loss) for the years ended December 31, 2008 and 2007, respectively follows:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Accumulated Other Comprehensive Income (Loss):</b>		
Balance, beginning of year .....	\$ (738,425)	\$ (10,147)
Currency translation adjustments.....	<u>(9,068,611)</u>	<u>(728,278)</u>
Balance, end of year.....	<u>\$ (9,807,036)</u>	<u>\$ (738,425)</u>

## **14. Commitments and Contingencies**

### ***Yemen***

In accordance with the Farm-in Agreement with the Oil and Gas Mine Company dated September 10, 2007, the Corporation is obligated to pay the Oil and Gas Mine Company \$3,000,000 upon a Declaration of Commerciality, which is defined as “the *act of approval by the Ministry of Minerals on the behalf of the Republic of Yemen for an operator to develop a Commercial Discovery under an existing production sharing agreement.*” The \$3,000,000 payment will only be incurred in the event the Corporation makes a commercial oil or natural gas discovery on Block 41 and the Ministry of Minerals grants a license to commercially produce such discovery. Due to the contingent nature of this item, it is not reflected in the Corporation’s Balance Sheet at December 31, 2008.

### ***Bakken Shale Drilling Commitment***

The Corporation entered into an agreement with a privately held Canadian company on August 28, 2008, whereby the Corporation agreed to pay 100% of the costs to drill a minimum of two horizontal wells in the Bakken shale in order to earn a 50% working interest in acreage controlled by the private company. The agreement was further amended on December 19, 2008, whereby the Corporation agreed to advance to the private company CDN\$2,712,000 prior to September 1, 2009 to drill the first earning well. Should the Corporation fail to do so, the Corporation must pay the private company liquidating damages of CDN\$2,000,000 and forfeit the Corporation’s rights under the agreement. In addition, the private company shall then acquire the Corporation’s other Bakken shale leasehold (purchased at the October 6, 2008 Saskatchewan Crown land sale and from Spartan on November 9, 2008) for CDN\$563,832.08. Furthermore, the private company is indebted to the Corporation in the amount of CDN \$439,205, as evidenced by a promissory note dated October, 6, 2008. The private company shall be entitled to offset the full amount that it may owe the Corporation should the Corporation fail to fund the first earning well and pay the liquidated damage amount outlined above.

### ***New York – Trenton-Black River Well Units***

In June 2005, a new integration statute was enacted by the State of New York whereby leasehold interest owners could elect to participate in the drilling of a well by choosing one of the following options:

- 1) Integrated non-participating owner – leasehold owner elects to not pay their proportionate share of costs up-front. The leasehold owner participates in their proportionate share after payout of a non-consent penalty plus costs.
- 2) Integrated participating owner – leasehold owner elects to pay their proportionate share of costs up-front.
- 3) Integrated royalty owner – leasehold interest owner elects to receive a proportionate 12.5% royalty interest.

During 2006, the Department of Environmental Conservation classified the Corporation's interest in several wells drilled prior to the statute change, and by way of public hearing, as an integrated non-participating owner. As a result, the Corporation was charged a non-consent penalty on its pro-rata share of costs to drill and complete various wells by Fortuna, the operator. The Corporation believes its interest in the subject wells should have been classified as an integrated participating owner upon payment of its pro-rata share of costs, effectively negating the non-consent penalty the operator could charge prior to disbursing the Corporation's pro-rata share of profits. The Corporation formally appealed the Department of Environmental Conservation's ruling, and, if successful, will require the non-consent penalty withheld by the operator to be disbursed to the Corporation. As a result there is no anticipated effect on the Corporation's established working interest. As at December 31, 2008, the outcome of the Corporation's appeal was not determinable.

As at December 31, 2008, the Corporation was classified as an integrated non-participating owner in 7 gross (0.10 net) wells, including 3 gross (0.06 net) for which the non-consent penalty had paid out.

### ***Office leases***

At December 31, 2008, the Corporation had the following offices:

- Traverse City, Michigan – office lease agreement effective April 1, 2007 with a two year term and monthly lease payments of \$4,375.
- Houston, Texas – office lease agreement effective November 26, 2008 with a five year term and monthly lease payments of \$6,347.
- Sana, Yemen - office lease agreement effective November 1, 2007 with a two year term and monthly lease payments of \$5,900.
- Abu Dhabi, United Arab Emirates: office lease agreement effective December 15, 2008 with a one year term and annual lease payment of \$57,183.
- Toronto, Canada - The Corporation's office in Toronto, Canada is owned by the Executive Chairman and is utilized at no charge to the Corporation. See Note 17 "*Related Party Transactions*".

The Corporation's future commitments are summarized in the following table:

	<b>Payments Due by Period</b>				
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1 – 3 Years</b>	<b>4 – 5 Years</b>	<b>After 5 Years</b>
<b>Future Commitments:</b>					
Long-term debt.....	\$ 34,573	\$ 15,574	\$ 18,999	\$ -	\$ -
Operating leases .....	499,016	200,707	228,492	69,817	-
Purchase obligations.....	\$ 2,712,000	\$ 2,712,000	-	-	-
Total .....	<u>\$ 3,245,589</u>	<u>\$ 2,928,281</u>	<u>\$ 247,491</u>	<u>\$ 69,817</u>	<u>\$ -</u>

#### ***Arbitration – Pinpoint Drilling and Directional Services LLC***

On November 5, 2008, the Corporation was notified by its contract operator that Pinpoint Drilling and Directional Services LLC (“Pinpoint”) had served a Notice of Arbitration covering invoices totaling \$1,158,550 for drilling services performed by Pinpoint on the Corporation’s Highway 706 project in Pennsylvania during 2008. At December 31, 2008, the Corporation had capitalized the entire disputed amount, including \$545,909 paid near the time the Notice of Arbitration was filed and the \$612,641 for which the Corporation has asserted is invalid due to negligent performance by Pinpoint and, which remained unpaid at year-end. The arbitration will take place in 2009. See Note 21 “*Subsequent Events*”.

## **15. Financial Instruments**

### ***Risk Management***

The Corporation, as part of its operations, enters into agreements which include financial instruments. The Corporation does not utilize derivative instruments to manage various types of risks. The Corporation is exposed to the following risks related to financial assets and liabilities:

#### ***Liquidity Risk***

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they become due. Liquidity describes a Corporation’s ability to access cash. Companies operating in the upstream oil and gas industry require sufficient cash in order to fund capital programs necessary to explore, develop and produce oil and natural gas, and to repay debt. The Corporation actively monitors its cash requirements to ensure it has sufficient available funds to meet current and foreseeable financial requirements at a reasonable cost. The Corporation prepares annual capital expenditure budgets, which are regularly monitored and updated as warranted. The Corporation also utilizes authorizations for expenditures to further manage capital expenditures.

At December 31, 2008, the Corporation had working capital of \$15,862,061, inclusive of restricted cash. See Note 9 “*Loan Facilities and Letter of Credit*”. In addition, the Corporation has commitments under existing agreements as described in Note 14 “*Commitments and Contingencies*”. Given the Corporation’s working capital position inclusive of restrictive cash, management assesses liquidity risk to be moderate.

#### ***Commodity Price Risk***

The Corporation sells its current oil and natural gas production at market rates and does not have any commodity based derivatives. Fluctuations in oil and natural gas prices can materially impact the current and future profitability of the Corporation. The Corporation analyzes commodity price risk by calculating the change in production revenues that would result from different commodity prices. For example, based on the \$9.30 per Mcf average natural gas price received from natural gas sales during 2008, a change in the price per Mcf of gas sold of plus or minus \$0.50 per Mcf would have resulted in a change of approximately \$375,000 (5.4%) in net income for 2008.

### ***Interest Rate Risk***

The Corporation maintains its short-term deposits in instruments that are redeemable within three months without penalty, and thereby is exposed to interest rate fluctuations. The Corporation does not utilize any interest rate based derivatives. The Corporation analyzes interest rate risk by calculating the effect of percent changes in the interest earned on its cash, cash equivalents and restricted cash. For example, a 10% plus or minus change in the 2.5% average interest rate earned during 2008 on the balance of the Corporation's average cash, cash equivalents and restricted cash during 2008 would have resulted in a change in net income of approximately \$110,000 for 2008.

### ***Foreign Currency Risk***

The Corporation is exposed to risks arising from fluctuations in foreign currency exchange rates, primarily between Canadian and U.S. dollars. The Corporation does not utilize any foreign currency based derivatives. Since its Initial Public Offering in 2007, the Corporation has held the majority of its short term investments in Canadian dollars. This strategy was effective until the exchange rate for Canadian to US dollars declined as much as 30% in favor of the US Dollar during October 2008. Management believes the drop in the exchange rate is a short term phenomenon. In order to manage this risk and to defer the realization of any resulting currency loss from converting Canadian dollars to US dollars, the Corporation has loan facilities in US Dollars totaling \$26,000,000 in place. At December 31, 2008, the outstanding balance of such loan facilities was \$19,184,134. See Note 9 "*Loan Facilities and Line of Credit*".

The Corporation regularly analyzes foreign currency risk between Canadian dollars and US dollars by calculating the effect of percent changes in the foreign currency exchange rates against period end cash, cash equivalents and restricted cash balances. For example, applying a 5% plus or minus change in the 0.8183 conversion rate of Canadian to US dollars at December 31, 2008 against the Corporation's average cash, cash equivalents and restricted cash balances during 2008 would have affected the value such balances by approximately \$2,500,000. Substantially all of the business operations are conducted in either US dollars or Canadian dollars.

### ***Credit Risk***

Credit risk arises from the possibility that the entities which the Corporation has receivables from or has invested in may experience difficulties and be unable to fulfill their obligations. The Corporation mitigates this risk of credit loss by taking a security interest in underlying assets of the investment. Accounts receivable are assessed on a regular basis by management to ensure the credit worthiness of debtors and the ultimate collection thereof. The Corporation's accounts receivable balances consist of receivables pertaining to its natural gas and oil production in New York and West Virginia and for pro-rata share of costs of operations from its joint interest partners in New York, West Virginia, and Yemen, all of which individually comprise in excess of 10% of the Corporation's overall accounts receivable balances. The Corporation's maximum credit exposure is approximately two months of oil and natural gas production for revenue receivables. The Corporation has the right to offset the amount owed by its joint interest partners against any revenue it disburses to them. As at December 31, 2008 and December 31, 2007, there are no provisions for doubtful accounts pertaining to accounts receivable balances for its oil and natural gas revenues or its joint interest partners.

As of December 31, 2008, the Corporation had a joint interest receivable from Oil and Gas Mine Company of \$5,590,881.84 for their pro-rata share of costs pertaining to Block 41. See Note 4 "*Accounts Receivable*" and Note 21 "*Subsequent Events – Oil and Gas Mine Company Default*".

### ***Fair Value***

The Corporation's carrying value of cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities, and notes payable approximate their fair value due to the immediate or short-term maturity of these instruments.

The Corporation's convertible debenture is a financial instrument which is made up of two components; a debt component and an embedded derivative component. Both components were separately accounted for, classified as "available for sale" and "held for trading", respectively, as of January 1, 2007 and were measured at their fair values. At December 31, 2007, management determined that the convertible debenture and each of its components were entirely impaired and recorded an impairment of \$1,115,419, which was equal to its outstanding principal plus accrued interest. See Note 6 "Investments".

## 16. Joint Ventures

The Corporation's proportionate share of assets, liabilities and cash flows of its joint ventures included in these consolidated financial statements as at and for the years ended December 31, 2008 and 2007, respectively, are as follows:

	<b>As at December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Assets and Liabilities:</b>		
Current assets.....	\$ 7,139,107	\$ 574,906
Property, plant and equipment <sup>(1)</sup> .....	\$ 94,312,255	\$ 64,682,160
Current liabilities .....	\$ 13,622,586	\$ 8,553,138
	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Revenues and Expenses:</b>		
Oil and natural gas revenues.....	\$ 8,377,027	\$ 3,670,159
Operating costs .....	\$ 1,792,252	\$ 538,977
<b>Cash Flows:</b>		
Cash flows from operating activities .....	\$ 2,267,515	\$ (3,536,137)
Cash flows investing activities .....	\$ (27,087,592)	\$ (32,816,281)

Notes:

- (1) Excludes \$34,071,330 for an unproved property impairment pertaining to Block 41 in Yemen. See Note 7 "Property and Equipment – Unproved Property Impairment".

## 17. Related Party Transactions

The Corporation reports its related party transactions on an exchange amount basis. A summary of such transactions follows:

### *Executive Chairman*

The Corporation utilizes administrative services provided by 706147 Ontario Inc., a company owned by the Executive Chairman and his spouse to assist in managing the Corporation's daily operations. In addition, the Corporation shares office space with Capital Z Corporation, a company owned by the Executive Chairman, at no charge. Related party transactions with the Corporation's Executive Chairman were conducted in Canadian dollars and the exchange rate differences were immaterial. A summary of related party transactions between the Corporation and its Executive Chairman follows:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>706147 Ontario, Inc.:</b>		
Administrative services.....	\$ 56,859	\$ 26,139
Accounts payable .....	\$ -	\$ 2,341
<b>Capital Z Corp:</b>		
Office space.....	\$ -	\$ -

During the year ended December 31, 2006, the Corporation invested in a convertible debenture with Peace River Oil Inc. for CDN\$1.0 million. It was a condition of the agreement between the Corporation and Peace River Oil Inc. that the Executive Chairman of the Corporation would also become a director of Peace River Oil Inc. The Executive Chairman resigned his directorship of Peace River Oil Inc. on January 30, 2007. In addition, as part of the agreement covering the convertible debenture, the Corporation acquired the right to explore for natural gas on approximately 9,000 (gross and net) unproved acres in the Peace River area. In management's opinion, this acreage has nominal value and there are no current exploration plans regarding such acreage. On December 12, 2007, Peace River Oil Inc. defaulted on the principal and the 9% interest due pertaining to the convertible debenture. As such, the Corporation recorded an impairment charge for the convertible debenture for the period ended December 31, 2007. See Note 6 "Investments".

**Director**

On February 7, 2007, the Corporation obtained a 25% undivided participating interest in Gastem Inc.'s undeveloped oil and natural gas interests covering approximately 1,184,000 gross (249,000 net) leasehold acres in the St. Lawrence Lowlands and in the Gaspé Peninsula of Quebec. Under terms of the agreement, the Corporation may elect to participate on a well-by-well basis with up to a 25% working interest in any current or future properties Gastem Inc. may acquire in Quebec. In return, the Corporation granted Gastem Inc. the right to participate for 25% of the Corporation's interest in future wells to be drilled in the Corporation's Amber Bank project in West Virginia by spending up to \$1.05 million. The Corporation's carrying value of the portion of its Amber Bank project's leasehold attributable to Gastem Inc.'s participation was nominal. The agreement was consummated with the expectation that Raymond Savoie, Gastem Inc.'s President, would become a director of the Corporation. Mr. Savoie became a director of the Corporation on July 16, 2007. See Note 7 "Property and Equipment". Related party transactions with Gastem Inc. were conducted in US dollars. A summary of related party transactions between the Corporation and Gastem Inc. follows:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Gastem Inc.:</b>		
Accounts receivable .....	\$ 21	\$ -
Joint venture costs .....	\$ 76,876	\$ 1,133,067
Joint venture revenues .....	\$ 309,917	\$ 120,803
Accounts payable .....	\$ 14,995	\$ 66,051

**Director and former President and Chief Executive Officer**

Austin Exploration LLC, a company owned by the Director and former President and CEO of the Corporation, is also a participant in the Corporation's New York acreage. Western Land Services Inc., a company owned by the same individual, provides oil and natural gas lease brokerage services to the Corporation in accordance with a Project Services Agreement between Western Land Services and the Corporation. Under terms of the Project Services Agreement, Western Land Services agreed to provide services to the Corporation at its lowest corporate rates less 10%. Substantially all of the services provided by Western Land Services are capitalized in oil and natural gas properties. In addition, Western Land Services provided the Corporation with office space free of charge from its inception in 2005 through March 31, 2007, at which time the Corporation began leasing office space from a third party in Traverse City, Michigan. Related party transactions with the Corporation's current director and former President and CEO were conducted in US dollars. A summary of related party transactions between the Corporation and its current director and former President and CEO follows:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Austin Exploration LLC:</b>		
Accounts receivable.....	\$ 109,562	\$ 55,693
Joint venture costs.....	\$ 2,654,594	\$ 826,020
Joint venture revenues .....	\$ 902,291	\$ 1,132,939
Accounts payable.....	\$ 75,115	\$ 10
<b>Western Land Services:</b>		
Lease brokerage services .....	\$ 1,667,898	\$ 3,188,360
Accounts payable.....	\$ 138,819	\$ 365,860
Office space .....	\$ -	\$ -

## 18. Changes in non-cash balances related to cash flows

Non-cash changes to the *Changes in Non-cash Balances Related to Operations* component of cash flows provided from operations for the years ended December 31, 2008 and 2007, respectively, were comprised of the following:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Changes to Non-Cash balances:</b>		
Accounts receivable.....	\$ (6,564,201)	\$ (361,799)
Notes Receivable .....	(359,401)	-
Other current assets.....	72,449	(323,389)
Accounts payable and accrued liabilities .....	(1,661,333)	277,769
Other changes.....	-	50,000
Total changes to non-cash balances related to operations.....	<u>\$ (8,512,486)</u>	<u>\$ (357,419)</u>

Non-cash changes to the *Additions to Oil and Natural Gas Properties* component of cash used in investing activities for the years ended December 31, 2008 and 2007, respectively, were comprised of the following items:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Additions to Oil and Natural Gas properties:</b>		
Total additions for year.....	\$ 52,446,870	\$ 55,075,646
Non-cash changes:		
Asset retirement obligations.....	(139,981)	(160,900)
Accrued liabilities .....	(6,796,440)	(6,646,932)
Cost of properties sold .....	1,754,896	-
Common Shares issued for acquisition of property interest .....	-	(6,000,000)
Rounding.....	(3)	-
Total cash additions to oil and natural gas properties .....	<u>\$ 47,265,342</u>	<u>\$ 42,267,814</u>

Changes to the *Proceeds from Issuance of Common Shares and warrants, Net of Issuance Costs* component of cash provided by financing activities for the years ended December 31, 2008 and 2007, respectively, were comprised of the following:

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Proceeds from the issuance of Common Shares and warrants, net of issuance costs:</b>		
Share Capital, beginning of year .....	\$ 109,725,936	\$ 20,028,270
Cash based changes:		
Cash proceeds from the issuance of Common Shares and warrants, net of issuance costs .....	31,256,168	83,407,649
Re-purchase of Common Shares .....	(691,404)	-
Non-cash changes:		
Valuation of re-purchased Common Shares .....	(2,042,710)	
Warrants issued .....	11,269	(11,269)
Shares issued for property interests .....	-	6,000,000
Stock options exercised .....	-	251,286
Common Shares issued to officer .....	-	50,000
Share Capital, end of year .....	<u>\$ 138,259,259</u>	<u>\$109,725,936</u>

## 19. Reportable Geographical Segments

As at December 31, 2008, the Corporation's operations by geographical area included Yemen, Ethiopia, United States, and Canada. See Note 7 "Property and Equipment".

Summarized reportable geographical segment data follows:

	<b>Year Ended December 31,</b>	
	<b>2008 <sup>(1)</sup></b>	<b>2007</b>
<b>Reportable Segments:</b>		
Yemen:		
Revenues .....	\$ -	\$ -
Operating costs .....	\$ -	\$ -
Capital expenditures .....	\$ 15,125,972	\$ 32,190,357
Deferred pre-operating costs .....	\$ -	\$ 510,361
Ethiopia:		
Revenues .....	\$ -	\$ -
Operating costs .....	\$ -	\$ -
Capital expenditures .....	\$ 1,851,114	\$ -
Deferred pre-operating costs .....	\$ -	\$ -
United States:		
Revenues .....	\$ 8,299,549	\$ 3,670,159
Operating costs .....	\$ 1,792,252	\$ 538,977
Capital expenditures .....	\$ 34,484,428	\$ 22,819,476
Deferred pre-operating costs .....	\$ -	\$ -
Canada:		
Revenues .....	\$ -	\$ -
Operating costs .....	\$ -	\$ -
Capital expenditures .....	\$ 534,638	\$ 65,813
Deferred pre-operating costs .....	\$ -	\$ -

Notes:

- (1) Excludes \$450,718 of miscellaneous capital expenditures pertaining to other countries within the Middle East for which there were no associated revenues, operating costs or deferred pre-operating costs.

## 20. Capital Disclosures

The Corporation defines its capital as follows:

- Cash and short-term investments
- Restricted cash, net of utilized lines of credit
- Unused line of credit

The amounts included in the Corporation's capital are as follows:

	As at December 31,	
	2008	2007
<b>Capital:</b>		
Cash and short-term investments .....	\$ 8,233,442	\$ 47,075,600
Restricted cash, net of utilized lines of credit .	\$ 14,519,174	\$ 1,100,000
Unused NW Bank loan facility - (Note 9).....	\$ 1,795,500	\$ 11,000,000

The Corporation's strategy is designed and formulated to maintain a flexible capital structure to allow the Corporation the ability to respond to changes in economic conditions, additional capital requirements, and the risk characteristics of the underlying assets of the Corporation. The Corporation considers the cash flows from the underlying assets and future capital needs when assessing the need for additional capital, if any. Depending on future liquidity requirements, the Corporation may invest its excess cash in short or long-term financial instruments. There were no material changes in the Corporation's approach to capital management or externally imposed capital requirements during 2008.

## 21. Subsequent Events

### *Block 41 – Yemen*

#### *Drilling results*

On January 9, 2009, the Corporation announced that the Kaninah #1 in Yemen was determined to be an exploratory dry hole after testing operations did not yield commercial quantities of oil. In addition, the Corporation announced that the test results from the West Mahrawa #2 yielded heavy oil with an API gravity of 4.62. Based on that test result, the West Mahrawa #2 is also considered to be uneconomic. As of December 31, 2008, the Corporation had incurred net capital costs of \$2,601,438 for the Kaninah #1 and \$3,668,495 for the West Mahrawa #2.

On February 26, 2009, the Corporation announced that the Mukulla #1 was determined to be an exploratory dry hole after testing operations did not yield commercial quantities of oil. As of December 31, 2008, the Corporation had incurred net capital costs of \$368,610 for the Mukulla #1.

#### *Oil and Gas Mine Company Default*

As of December 31, 2008, the Corporation had outstanding receivables from Oil and Gas Mine Company of \$5,590,881 for their pro-rata share of costs pertaining to Block 41. On March 3, 2009, the Corporation sent Oil and Gas Mine Company a notice of default for failure to pay such amount. Under terms of the Block 41 PSA, Oil and Gas Mine Company has thirty days from the date of default to pay such amount. In the event that Oil and Gas Mine Company fails to cure the default, the remaining working interest partners may assume Oil and Gas Mine Company's interest in proportion to their working interest.

### ***Block 55- Sultanate of Oman (“Oman”)***

On January 26, 2009, the Corporation was awarded a 100% working interest in Block 55, an onshore oil and natural gas concession in Oman that covers approximately 7,564 square kilometers (1,869,105 acres). In management’s opinion, Block 55 is prospective for commercial oil and natural gas exploitation. Exploration plans during the initial three year exploration program include acquiring 800 kilometers of seismic data, reprocessing 4,133 kilometers of existing seismic data and a drilling program covering a minimum of four initial exploratory wells designed to exploit Block 55’s oil and natural gas potential.

Terms of the Exploration and Production Sharing Agreement (“EPSA”) include an initial bonus payment of \$2,000,000 and a commitment to spend a minimum of \$25,500,000 over an initial three-year exploration period comprising the following items:

- 3D seismic: acquire 300 square kilometers; reprocess 133 square kilometers
- 2D seismic: acquire 500 square kilometers, reprocess 4,000 square kilometers
- Drill four wells

At the Corporation’s option, the initial exploration period can be extended for an additional three year period provided the Corporation commits to spend \$28,500,000 comprising the following items:

- Acquire 600 square kilometers of 3D seismic or 500 square kilometers of 2D seismic
- Drill three wells

Commercial crude oil production carries a contractual term of 20 years and will be allocated as follows:

- 40% of crude oil production is designated for cost recovery.
- 60% of crude oil production is designated as profit oil and will be allocated as follows:
  - Up to 10,000 bbls/d - 80% government of Oman; 20% Operator
  - 10,000 to 20,000 bbls/d - 82.5% government of Oman; 17.5% Operator
  - Over 20,000 bbls/d - 83.5% government of Oman; 16.5% Operator

The Corporation is obligated to pay income taxes to the government of Oman. However, under terms of the Block 55 EPSA, the government of Oman undertakes to pay such taxes on behalf of the Corporation from the government of Oman’s share of crude oil and/or gas.

The Corporation is the official operator of Block 55 and is considering bringing in industry partners, raising additional capital, or a combination of both to fund the exploitation of this concession. Leaving aside the \$2,000,000 bonus payment, the Corporation does not expect to spend a significant amount of capital towards this concession until 2010 or later.

### ***Highway 706 Drilling Contractor***

On November 5, 2008, the Corporation was notified by its contract operator that Pinpoint had served a Notice of Arbitration covering invoices totaling \$1,158,550 for drilling services performed by Pinpoint on the Corporation’s Highway 706 project in Pennsylvania during 2008. At December 31, 2008, the Corporation had capitalized the entire disputed amount, including \$545,909 paid near the time the Notice of Arbitration was filed and the \$612,641 for which the Corporation has asserted is invalid due to negligent performance by Pinpoint and, which remained unpaid at year-end. The arbitration will take place in 2009.

Drilling services performed by Pinpoint on Highway 706 to date has been in accordance with a drilling contract dated May 16, 2008 between Pinpoint and the Corporation’s contract operator for a term of one year. Under terms of the Contract, the Corporation is subject to a stand-by day rate of \$14,800 per day. On February 17, 2009, the Corporation, through its contract operator, informed Pinpoint that the Corporation’s Board of Directors had approved terminating the drilling contract upon completion of drilling the Hardic 2H. Pinpoint completed drilling the Hardic 2H on March 18, 2009.